Business

SA counts cost of poor governance

If investors take a proactive oversight role, capital can be allocated to well-run entities

COMMENT
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Capture victims: Shoddy governance in the public and private sectors has diverted money away from the poorest of the poor. Photo: David Harrison

What role have investors played in the degradation of South Africa's governance standards, and how can they help to repair the damage?

Investors represent a vital part of a modern economy in that they allow their savings to be channelled towards productive enterprises. Asset managers are often entrusted to fulfil this role of allocating capital. Investment should always be done in accordance with risk-return principles and be based on reasoned analysis.

In recent years, investors' research has moved beyond mere macroeconomic, industry and financial analysis to include a range of indicators about the sustainability of businesses. We have learned that environmental failures, social mismanagement or poor governance can destroy companies. Although investors often rely on laws, codes and watchdogs (such as regulators, auditors and ratings agents) to give some comfort, "bad actors" regularly break the rules in the pursuit of personal gain.

Time and again we have seen the overarching pursuit of near-term profit leading corporate decision-makers away from sustainable choices and on to the shoals of disaster. Recent events in South Africa's state-owned enterprises and some large private companies have shown us that the risks of governance failure — and therefore the need for governance checks and balances — apply equally to both public and private companies.

We often employ professionals as "agents" to act in our interests. This can range from attorneys and asset managers to business managers who care for shareholders' assets. In fact, government or parastatal employees are "agents" appointed by citizens to care for the assets of the nation.

However, when business managers are charged with looking after others' interests, there is potential for conflict between what is good for the agent versus what might be best for their constituent investors. This is the well-known "agency problem" that must be managed with rules, reporting, contracts, oversight and culpability.

The need for checks and balances to address the agency problem is not new. When, for example, governments act on behalf of citizens, they are guided by constitutions, controlled by laws and regulations, overseen by watchdog agencies, policed by a free and unfettered press, and are accountable to a populace who can institute change when necessary.

Likewise, investors are one of the pillars of oversight for the nation, but they often seem to operate in a flawed subsystem that impairs them from exercising that role. We need to understand those impediments.

In overseeing companies, the agency problem is subtle: whereas a chief executive may own shares alongside other investors, she might argue for a corporate jet to satisfy her own desires, or may be driven by the structure of her bonus scheme to seek short-term gains or to take on undue risks. Therefore, even though alignment (for example, through shareholding) may appear to solve many ills for shareholders, what is really required is a "web" of oversight by stakeholders and watchdogs.

Profit motive sparks conflicts

In the realm of investing there is a chain of agents notionally acting for investors — but corporate managers, asset managers, auditors, ratings agents and exchanges are all profit-seeking parties who may not always hold investors' interests at the pinnacle of their concerns. Even among genuine fiduciaries, there may be conflict between the need to perform multiple layers of analysis and oversight while meeting investors' relentless demands for lower costs and fees.

Perhaps most pernicious, it is possible for well-intentioned agents to act credibly to protect their own clients' interests while failing to address structural problems in markets and regulations that hurt all their clients and all investors.

For example, who is responsible for ensuring capital markets are fair, or ensuring the efficacy of standards of reporting on governance by entities with listed bonds or shares? The answer is that — even while exchanges, analysts and ratings agents earn fees, asset managers buy the instruments for investors, and regulators simply tag along — no one in particular takes responsibility for ensuring the overall market system is safe and suitable. As a result, it is not safe and suitable.

Regulators — whose job is specifically to look after all investors — tend to be understaffed and overburdened by a system that has been shaped by the motives of various players who are able to deploy "divide and conquer" tactics for self-gain and to overcome the principles of fairness and accountability. There is a presumption that "someone" will create a protective environment for investors, but no party actually takes responsibility to ensure that such an environment exists.

The belief that regulators, ratings agents, exchanges or others are overseeing the governance of companies — or that the well-intentioned King Code serves to protect investors — is simply untrue. Therefore, the mantra of *caveat emptor* (let the buyer beware) fails to protect investors when others are acting on their behalf or when there is a systemic insufficiency of standards, transparency or honesty.

Governments are formed by negotiation among citizens, and then systematically improved with additional laws, court rulings, controls and oversight. By contrast, economic, corporate and market practices have evolved without a guiding vision and have systematically failed to embed the learnings from past failures or malfeasance. It has been observed that "progress in the field of finance is cyclical, not cumulative".

Investors fail to learn from history and tend to repeat the mistakes of their forebears. Although they acknowledge that the governance of investee companies is important, and that assessing governance is part of an analyst's job, the tools and methods deployed are relatively weak.

For example, many investors employ governance checklists: "Does a company have an audit committee?", "Is the chair of the remuneration committee independent?" and so forth. Such tick-box assessments fail to address the real, deeper measures of sound governance — or to assess the challenges of "governance policy" put into "governance practice".

Investors have been so placated that when governance failures occur, these events can be palliatively attributed to a "one-off", a "lone wolf" or a "bad actor", rather than being seen more truthfully as repeating systemic failures that can, and should, be addressed and remedied.

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SA still staring into the abyss

In recent years, South Africa has faced an alarming decay of governance in its government departments and its parastatals. There has been a systematic programme to capture and pillage the nation for personal financial gain.

We have just witnessed the near-death of South Africa's young democracy. Only the combined efforts of well-intentioned individuals in politics, agencies, parastatals, the judiciary and civil society have allowed the darkness to be exposed.

South Africa has, not for the first time in its history, looked into the abyss and chosen not to jump. But we may still be standing at the edge, and we must not forget how close the nation came to the precipice.

The systemic implications of poor governance have real-world, on-the-ground consequences. Any first-year economics student can tell us that the three vital factors of production in an economy are land (resources), labour (skills) and capital (access to finance). To compete in the global economy for opportunities, growth and jobs requires accessing these three factors at a competitive cost.

The cost of capital (the return demanded by investors) is a function of the risk investors take. The notable governance failures by some parastatals and corporations is a clear sign that South Africa is a risky investment destination — which results in increases in the country's cost-of-capital, reducing economic growth and opportunities for all.

Although the economic theory may sound arcane, the damage is clearly demonstrable. It has been estimated that up to R100-billion, about half of our fiscal deficit, may have been misappropriated by government and parastatal malfeasance. That means South Africa's government deficit spending (and government borrowing) is higher, and the national debt as a percentage of the economy is that much worse.

Adding insult to injury, none of that stolen money has been invested for service delivery or for future prosperity. As a result, South Africa's global credit quality has deteriorated, confidence has been shattered, there has been a paucity of capital investment, and the cost of borrowing to fund houses, education, infrastructure and businesses has risen — for all South Africans. The economy is not growing, and is not globally competitive. The cost of governance failures is real, tangible and terrible.

During the past 18 months, by engaging with some of South Africa's largest parastatals, the Futuregrowth analytical team has undertaken to understand how governance works in practice, and ascertain how it can be reshaped and improved. We have learned to make governance "real" — to take it beyond tick boxes and dig down into how it is practised.

We believe that these lessons can be embedded in various regulations and, notably, market-listing requirements. Governance reporting at present is remarkably vague, and should be vastly improved so that investors can play their suitable role in oversight and the allocation of capital to sustainable, well-managed entities.

The investment market standards of reporting on governance matters are pathetic and weak, seem designed to pull the wool over investors' eyes, and are overdue for radical improvement.

Our work has led us into direct dialogue with some of South Africa's largest parastatals and their shareholding ministers. We have made some headway, but it is evident that the task of reforming state enterprise and corporate governance is not something that should be done by one (or even a few) players, but by a wider group of engaged parties.

The best outcome is to ensure governance standards and practices are principled, robust and sustainable — so that they don't impair the work of the perfectible but serve to emasculate the corruptible.

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